Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM 1976

No. .....

76-1402

POIRIER & McLANE CORPORATION,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner, Poirier & McLane Corporation, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on November 23, 1976.

Opinions Below

The opinions of the Court of Appeals (pages 1a-21a) are officially reported in 547 F2d 161. The opinions of the United States Tax Court (pages 22a-43a) are officially reported in 63 T. C. 55.

Jurisdiction

The judgment of the Court of Appeals was entered on November 23, 1976. A timely petition for rehearing con-

taining the suggestion that the appeal be reheard en banc was denied on January 10, 1977.

The jurisdiction of the Court is invoked under 28 U.S.C. Section 1254 (1) and Rule 19 (1)(b) of the Supreme Court Rules.

Questions Presented

I. Did the taxpayer properly deduct from its 1964 taxable income the sum of $1,100,000.00 which it delivered to a trustee of an irrevocable trust to be used for the payment of claims which were asserted against the taxpayer which the taxpayer was contesting at the time of the transfer and continued to contest after the transfer?

II. Did the taxpayer comply with the Treasury Regulations as determined by the Tax Court in the majority opinion written by trial judge Honorable C. Moxley Featherston, in that, properly interpreted, that Regulation did not require the signature of the claimant beneficiaries?

III. If the Regulation required that the claimant beneficiaries physically sign the deed of trust, is that portion of the Regulation valid?

IV. Should the Supreme Court exercise its jurisdiction in this case of first impression to determine the course to be pursued by taxpayers in the future with respect to their right to take deduction with respect to a contested claim as provided by the appropriate Statute?

Statutes Involved

The Statute involved is Section 461(f) of the Internal Revenue Code of 1954, as amended, which is set forth at page 44a. The Regulation involved is Section 1.461-2 (c) which is set forth at pages 44a-46a.

Statement

The facts as stipulated by the parties and as set forth in the opinions of the United States Tax Court and the United States Court of Appeals for the Second Circuit are as follows:

Subsection (f) was added to Section 461 of the Internal Revenue Code in 1964. It permits a deduction of the amount transferred by the taxpayer for the satisfaction of a contested asserted liability where the contest exists after the time of the transfer.

By Treasury Regulation Section—1.461-2(c) the taxpayer may provide for the satisfaction of the asserted liability by transferring property beyond his control to a trustee pursuant to a written agreement among the trustee, the taxpayer, and the person who is asserting the liability.

Petitioner (hereinafter referred to as taxpayer) pursuant to a deed of trust signed by it and Manufacturers Hanover Trust Company, a professional trustee (but not by the claimants), delivered to the trustee a certificate of deposit and seven United States Treasury Bills in the total face amount of $1,200,000.00 for the satisfaction of contested claims pending against it. Taxpayer deducted from its taxable income for the year 1964 the sum of $1,100,000.00 being the market value of the certificate of deposit, and the treasury bills.

The issues presented are:

(1) whether the taxpayer had, in fact, complied with the regulation (Section 1.461(c)) or, in the alternative;

(2) whether, if such regulation requires that the person asserting the liability sign the trust agreement, that portion of the regulation is invalid; and

(3) whether or not the taxpayer had placed the property which it delivered to Manufacturers Hanover Trust Company beyond its control.

In 1964 the taxpayer, a corporation, was a party to a contract with the City of New York to reconstruct a portion of a subway and to enlarge a subway station. In that year it was also a party to a contract with the State of New York to build a parkway. In each of these contracts taxpayer was obligated to indemnify and hold harmless the city and the state respectively from any and all suits resulting from work performed under these contracts.

In 1964 there were pending in the Supreme Court of the State of New York suits by eight claimants against the petitioner for damages alleged to have been sustained as a result of the work performed under the contract with the City of New York in which the amount of damages claimed was $561,150.00. In that year there was also pending a suit by Bronxville-Palmer, Ltd. against the State of New York and the taxpayer wherein the claimant sought damages in the amount of $14,200,000.00 based upon the alleged negligence and trespass of the taxpayer.

In 1964 the Internal Revenue Code was amended by adding thereto Section 461(f) which permitted a taxpayer to deduct from its taxable income in the year of transfer sums transferred to provide for the satisfaction of a contested asserted liability where the contest with respect to the asserted liability exists after the time of transfer.

The taxpayer was not insured against damages caused by trespass and the limit of the policy insuring against damages caused by negligence was $500,000.00. Acting upon the advice of its insurance agent, its accountant, and its attorneys, taxpayer set up a reserve of $1,100,000.00 for the payment of these pending litigations, and, on or about December 31, 1964 taxpayer as settlor, entered into an agreement with the Manufacturers Hanover Trust Company, as trustee, to create an inter vivos trust. Pursuant to that agreement taxpayer delivered to the Manufacturers Hanover Trust Company, as trustee, securities with the market value of $1,100,000.00 which the trustee was to hold pursuant to the trust agreement for the purpose of paying the claimants enumerated in the trust agreement, which claims were being contested, when those claims were settled or resulted in a judgment against the taxpayer.

The claimants, who were plaintiffs in the pending actions, did not sign the trust agreement. Taxpayer deducted the sum of $1,100,000.00 from its taxable income for the year 1964 pursuant to the provisions of the Internal Revenue Code 1954 Section 461(f).

Between December 1964 and October 1969 all of the litigation of the claims asserted by the claimants named in the trust agreement had been finally determined. The litigation based upon negligence resulted in an award by the New York State Court of Claims on September 8, 1969 of damages in the sum of $11,600.00 which was well within the taxpayer's insurance coverage.

In October 1969 the taxpayer advised the trustee, Manufacturers Hanover Trust Company, that all the claims and suits enumerated in the trust agreement had been finally disposed of and requested that the fund be paid to it pursuant to the trust agreement. At the same time taxpayer's attorneys gave its opinion to the trustee that the lawsuits enumerated in the trust agreement had been terminated and that none of the claimants enumerated in the trust agreement had any present claim against the taxpayer. Thereupon, the trust company delivered to the taxpayer the corpus of the trust.

On the audit of the taxpayer's 1964 return the agent disallowed the deduction from taxpayer's taxable income of $1,100,000.00, the value of the property transferred to the trustee pursuant to the deed of trust, upon the ground

that the taxpayer had not complied with regulation Section 1.461-2(c).

The jurisdiction of the United State Tax Court was invoked under 26 USC Section 7442 wherein taxpayer instituted a proceeding for a redetermination of this deficiency alleging that the Commissioner erroneously determined that the taxpayer had improperly deducted the sum of $1,100,000.00 from its taxable income.

The Tax Court, divided six to four, held for the taxpayer. The majority opinion (pages 22a-38a) written by the trial judge Honorable C. Moxley Featherston determined that the taxpayer had complied with the treasury regulation, and, that properly interpreted, the regulation did not require the signature of the claimant beneficiaries (37a & 38a). The concurring opinion (page 39a) by Judge Forrester in which Judges Fay, Sterrett, Goffe and Wiles joined, stated:

> "I concur in the result reached by the majority, but think the here critical portion of regulations section 1.461-2(c)(1) should be declared invalid if it is read as requiring the claimant-beneficiary to sign the written agreement."

A dissenting opinion by Judge Hall in which Judges Raum, Simpson and Quealy joined stated that the transfer did not meet the literal requirements of the regulations (pages 39a-43a). Both the majority and the dissenting opinions found that taxpayer had created a valid trust (36a and 40a).

The Court of Appeals, divided two to one, reversed. A petititon for a rehearing en banc, made because the question is one of first impression on which the majority of the judges in both courts did not agree with the decision of the Court of Appeals, was denied.

Ruling Below

The Court of Appeals upheld the validity of the regulation holding that: "• • • the regulation plainly requires the person asserting liability to be a party to the trust agreement. Because we are convinced the Regulation contributes to the fairness to the tax structure by limiting Section 461(f) to its intended scope, and is designed to forestall potential abuses, we uphold its validity" (page 2a).

Reasons for Granting the Writ

I. This is a case of first impression. The Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this court.

II. The proper determination of the validity of the Treasury Regulation transcends the present case; it is controlling with respect to all taxpayers similarly situated to petitioner.

I

This is a case of first impression. The Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this Court.

The majority of the Court of Appeals, in error, relied upon *Ehag Eisen. Holding A. G.* v. *Banca Nat. a Romanieri,* 306 N.Y. 242 (12a). This case has no application. That court held that a trust had not been created but that the relationship was that of debtor and creditor (the usual depositor and bank relationship) coupled with an agency. (The United States Tax Court was unanimous in finding that a valid trust had been created in this case.) They further erred in their conception and application of

the prophylactic measure (13a). Such measures are unnecessary, for if, in fact, the settlor does not relinquish full control of the property transferred he has not made the transfer required by the statute and intended by the Congress.

Prior to the enactment of Section 461(f) of the Internal Revenue Code of 1954 in 1964 before an accrual basis taxpayer could claim a deduction all the events must have occurred which would have finally established the facts of liability and the amount thereof. This rule was based upon the decisions in *Dixie Pine Product Co.* v. *Commissioner,* 320 US 516; *Security Flour Mills* v. *Commissioner,* 321 US 281.

The new statute provides that where the taxpayer contests an asserted liability, transfers money or other property to provide for the satisfaction of the asserted liability and the contest with respect to the asserted liability exists after the time of the transfer the deduction shall be allowed for the taxable year of transfer.

In this case the petitioner did everything which the statute required it to do.

The Treasury Regulation provides that the taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a trustee pursuant to a written agreement (among the trustee, the taxpayer and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest.

The petitioner complied with all of the provisions of the statute. That taxpayer did not have the claimants sign the deed of trust, and, if the signatures be required, did not comply with the regulation.

The deed of trust was signed by the settlor and by the trustee, Manufacturers Hanover Trust Company, to which the taxpayer delivered property of the market value of

$1,100,000.00 to be held by the trustee in trust for the payment of the claims which were enumerated in the deed of trust when those claims were settled or resulted in judgments against the petitioner.

The signing of the deed of trust by the settlor and the trustee and the delivery by the former to the latter of the property which was to constitute the corpus of the trust created an irrevocable trust, definitely and decisively fixing the rights and obligations of the trustee and the beneficiaries, who were primarily those asserting claims against the petitioner, with the petitioner as a contingent remainderman.

Petitioner requests this court to construe the regulation and to determine whether or not it, in fact, requires the persons asserting the liability to sign a trust agreement, and, in the event the court determines that the regulation does require the persons asserting the liability to sign the agreement, then to declare that portion of the regulation to be invalid.

The regulation should be construed not to require the signatures of the persons asserting the liability for the trust agreement is, in fact, among the settlor of the trust, the trustee, and the persons asserting the liability, who are beneficiaries, because the rights of all are fixed by the trust agreement and the applicable law of the State of New York. New York State Estates, Powers and Trust Law (cited EPTL) Section 7-1.1, Section 7-1.4, Section 7-1.9.

An express trust vests in the trustee the legal estate, subject to the execution of the trust, and the beneficiary does not take any legal estate in the property but may enforce the trust. Section 7-2.1 EPTL. Any and all acts of the trustee in contravention of the trust except as authorized by law are void. Section 7-2.4 EPTL. The rights and obligations of trustee, and the rights of all the beneficiaries in and to the corpus thereof, came into being when the deed of trust was executed by the creator and the trus-

tee, and the property which was to constitute the corpus of the trust was transferred by the creator to the trustee with the intention of passing legal title to the trustee. (EPTL Section 1-2.2) in *Re Palumbo's Estate,* 284 App.Div. 834, 132 N.Y.S. 2d 386; *Ihmsen's Estate,* 253 App. Div. 472, 3 N.Y.S. 2d 125; *City Bank Farmers Trust Co.* v. *Charity Organization Society of the City of New York,* 238 App. Div. 720, 265 N.Y.S. 267, aff'd 264 N.Y. 441.

It is not necessary for the cestui que trust to be party to the trust agreement nor even to be informed of the existence of the trust. In Re *George's Estate,* 1 Con. 241, 3 N.Y.S. 426.

The essential elements for the creation of a trust are present in the transaction of December 31, 1964 between the petitioner and the Manufacturers Hanover Trust Company, a professional trustee. Those elements have been defined as follows: the essential elements for the creation of a trust of personalty are, designated beneficiaries, a designated trustee other than the beneficiary, a fund or other property sufficiently described, designated, or identified to enable title thereto to pass to the trustee, and the actual delivery of the fund or other property, or the legal assignment thereof to a trustee, with the intention of passing legal title thereto to it as trustee. In Re *Goldenberg's Will,* 213 N.Y.S. 2d 225. All of the above elements are present in this case.

The nature of an estate created by a trustee is determined once and for all at the moment of the legal inception of the trust. *City Bank* v. *Miller,* 278 N.Y. 134.

The creation of a trust, in addition to giving the cestui que trust a chose in action to enforce the performance of the trust, imposes a concomitant obligation upon the trustee, who, acting in a fiduciary capacity, is charged with an active obligation to effectuate the ends of the trust it has accepted, and to protect the interest of the cestui que

trust in the trust fund. Articles 4 and 77, Civil Practice Law and Rules, EPTL Section 7-2.4, in Re *Edward's Trust,* 142 N.Y.S. 2d 169; *Genesee Valley Trust Co.* v. *Newborn,* 168 Misc. 703, 6 N.Y.S. 2d 498; *Mixsell's Trust,* 186 N.Y.S. 2d 396; *Prudence Co.* v. *Central Hanover Bank & Trust,* 262 N.Y.S. 311, 237 AD 595 aff'd 261 N.Y. 420; EPTL Section 7-1.9; *Schoellkopf* v. *Marine Trust Co. of Buffalo,* 267 N.Y. 358.

If it be determined that the petitioner, by the agreement with the trustee, fixed the rights of the trustee, the petitioner, and the persons asserting the liability, but did not comply with the regulation because the persons asserting the liability did not sign the deed of trust, then so much of the regulation as requires the persons asserting the liability to sign the written agreement or deed of trust is, and should be declared, invalid.

That portion of the regulation is invalid because it legislates rather than regulates, it is unreasonable and impractical, it modifies the provisions of the statute, and it adds restrictions and conditions to the statute which were not contemplated by the Congress, *Morrill* v. *Jones,* 106 U.S., 1 S.Ct. 423; *General Electric Company* v. *Burton,* 372 Fed. 2d 108; *Miller* v. *Commissioner,* 237 Fed. 2d 830; *Royer's Inc.* v. *United States,* 265 Fed. 2d 615; *Smith* v. *Commissioner,* 332 Fed. 2d 671; *Whitney Land Company* v. *United States,* 324 Fed. 2d 33; *Boykin* v. *Commissioner,* 260 Fed. 2d 249; *Scofield* v. *Lewis,* 251 Fed. 128; *Busey* v. *Deshler Hotel Co.,* 130 Fed. 2d 187.

There is no requirement in the statute that the claimant sign the trust agreement. In the Senate Reports and in the Conference Report there is no indication that the Congress contemplated or required that the claimant would be a party to the trust agreement. The intent of Congress is evidenced by its feeling that the property transferred should be beyond the control of the taxpayer. The transfer in the instant case meets this test.

The Court should consider the practical aspects and considerations which enter into the settlement and disposal of negligence actions. One of the most important considerations is the financial responsibility of the defendant, and the likelihood of collection of any judgment which may be agreed upon in settlement of the action. No reasonable man, defendant in a negligence action, would consider transferring money or other property to an indigent plaintiff while continuing to contest the action, nor would he tell such a plaintiff that he was about to transfer money or other property to an escrow agent or trustee pursuant to a written agreement that the money or other property be delivered in accordance with the settlement of the contest and request him to become a party to such agreement. The regulation is unreasonable in that it requires him so to do.

If compliance with as much of Regulation 1.461-2(c) as requires the claimant to sign the written agreement is held to be valid, the claimant could prevent the taxpayer from taking the deduction provided for him by Section 461(f) of the Code by arbitrarily refusing to become a party to any escrow or trust agreement. Surely this was not intended by the Congress.

As much of the instant regulation as requires the person asserting the liability (who may be, as is the case with this taxpayer, the plaintiff in a negligence action) to sign the trust or escrow arrangement pursuant to which money or property is transferred for the settlement of the claim is not only unreasonable, it is unreal.

The taxpayer in the instant case met all of the requirements and complied with all of the provisions of the statute. As much of the regulation as requires the claimant to sign the escrow or trust agreement is, and should be adjudged to be, invalid. We respectfully request this Court to make that determination.

II

The proper construction of the validity of the Treasury regulation transcends the present case.

The construction of the regulation by the Court of Appeals will be the law binding upon all taxpayers. It is in error. It creates a hardship. It prevents taxpayers from realizing a deduction the Congress intended should be available to them—Senate Supplemental Report, last paragraph, page 50a.

> "The new subsection (f) is not limited to an asserted liability for taxes, *but applies to any asserted liability where the requirements of the new subsection (f) are met.* A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to a person who is asserting the liability *or by a transfer to an escrow agent provided the money or other property is beyond the control of the taxpayer.*" (italics supplied).

Conclusion

On the uncontroverted facts an order should be made and entered granting a writ of certiorari to review the decision of the Court of Appeals.

Respectfully submitted,

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APPENDIX

Opinion of the United States Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 15—September Term, 1976.

(Argued October 6, 1976 Decided November 23, 1976.)

Docket No. 76-4062

POIRIER & McLANE CORPORATION,

Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

Before:

KAUFMAN, *Chief Judge,*
MANSFIELD and MESKILL, *Circuit Judges.*

Appeal from a decision of the United States Tax Court allowing a deduction of $1,100,000 in the year transferred to a trust established for the satisfaction of contested liabilities, but created without the agreement of the persons asserting the liability.

Decision reversed and remanded for recomputation of deficiency.

ROBERT A. BERNSTEIN (Gilbert E. Andrews, John G. Manning, Attorneys, Scott Crampton, Assistant Attorney General, Tax Division, Department of Justice, Washington, D.C. on the brief), *for Appellant.*

EDWARD ST. JOHN (St. John and Dougherty, Port Washington, N.Y., on the brief), *for Appellee.*

KAUFMAN, *Chief Judge:*

In 1964, Congress enacted § 461(f) of the Internal Revenue Code to achieve a more equitable and rational matching of liability disbursements and receipts for accrual basis taxpayers. It permitted deduction of a liability, even if contested, provided a transfer was made in that tax year to satisfy the claimed liability. The Internal Revenue Service, to effectuate the statutory intent and avoid potential abuse, promulgated Regulation 1.461-2(c)(1)(ii). It permitted a taxpayer to obtain a deduction by transferring money:

> . . . to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) . . .

We are called upon to decide whether a transfer of funds to a trustee for payment of an asserted liability sometime in the future was deductible under the Regulation, although the claimants were concededly not parties to the agreement. We must also decide whether the requirement of such assent faithfully interprets the intent of the statute. We believe the Regulation plainly requires the person asserting liability to be a party to the trust agreement. Because we are convinced the Regulation contributes to the fairness of the tax structure by limiting § 461(f) to its intended scope, and is designed to forestall potential abuses, we uphold its validity. Accordingly, we reverse the Tax Court's allowance of a deduction for this payment and remand for a calculation of tax liability.

A concise narration of the facts, which are not disputed, will aid in the consideration of the legal issue. Poirier & McLane Corporation, an accrual basis taxpayer, was a contracting firm specializing in road, bridge and tunnel construction.[1] In January, 1956, the company received a contract from the New York City Transit Authority to reconstruct a subway tunnel and enlarge a subway station in Brooklyn. The Corporation undertook to indemnify the Transit Authority for all claims arising out of the work performed. By the time the project had been completed, several owners and tenants of property in the vicinage of the construction site had filed negligence and trespass suits against the company. The claims aggregated $581,150.

In October 1958, Poirier & McLane secured from New York State a contract to act as general contractor for the construction of a parkway in Yonkers. The agreement contained the familiar indemnification provision. Poirier & McLane engaged a subcontractor, Raymond Concrete Pile Co., to install the road support pilings. It was charged that the subcontractor performed this work improperly, and by driving pilings into an apartment building adjacent to this construction permanently damaged its foundation. In 1960, the building's owner, Bronxville-Palmer, Ltd., sued Poirier & McLane, Raymond Pile, and the State of New York for negligence and trespass seeking $14,200,000 in damages.

Although Poirier & McLane was insured for aggregate negligence claims up to $500,000, its policy did not cover liability for trespass. Consequently, the company's counsel

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[1] At the time this case came before the Tax Court, Poirer & McLane, because of business reversals, was in the process of liquidation.

advised that a reserve be set aside to enable Poirier & McLane to pay possible judgments on the uninsured tort claims. Poirier & McLane's accountant suggested also, that this segregation of funds could be accomplished and an immediate tax deduction taken by placing the money in a trust for the payment of asserted liabilities arising from the Yonkers and Brooklyn construction contracts. Accordingly, Poirier & McLane entered into a trust agreement with Manufacturers Hanover Trust Company. Manufacturers Hanover, as trustee, received $1,100,000 (in a certificate of deposit and Treasury bills), to be held in trust for the sole purpose of paying taxpayer's obligations on the pending claims and which were allocated in the following manner:

	Claim	*Reserve*
The Yonkers Construction	$14,200,000	$900,000
The Brooklyn Construction	581,150	200,000

The agreement provided that Manufacturers Hanover would return the balance of the fund after disposition of the claims:

> . . . on the statement of the Settlor that the claims, for the satisfaction of which this transfer has been made, have been determined and disposed of.

In its 1964 tax return, Poirier & McLane, an accrual basis taxpayer, deducted $1,100,000, on the ground that its transfer of money to the trust constituted payment of a "contested liability", deductible under 26 U.S.C. § 461(f). On January 20, 1972,[2] a statutory notice of deficiency was issued to Poirier & McLane, disallowing the deduction and

[2] By agreement, issuance of the notice of deficiency was delayed until a final decision was rendered in the Bronxville-Palmer litigation.

requesting payment of $624,485.37 in additional tax. On April 14, 1972, Poirier & McLane filed a petition in the United States Tax Court, challenging the disallowance and denying the existence of a deficiency[3] and by a divided court it ruled against the Commissioner.[4]

None of the claimants in any of the pending actions signed this trust agreement, nor were they notified of the existence of the trust. This failure has spawned the legal issue which caused the serious division in the Tax Court.

Judge Featherston, writing for the majority, concluded that Regulation 1.461-2(c)(1)(ii) did not require the persons asserting liability to be parties to the trust agreement. Accordingly, he allowed the deduction of the $1,100,000 placed in trust in 1964. Judge Forrester, in an opinion joined by four other judges, concurred in the result, but added that if the Regulation did contain such a requirement, they would declare that portion of the rule invalid. Judge Hall, in a dissenting opinion joined by three other judges, argued that the claimants assent was required by the Regulation, and that this requirement was a reasonable interpretation of the statutory intent of § 461(f).

[3] In October 1969, Poirier & McLane notified Manufacturers Hanover that all claims enumerated in the trust agreement:

> . . . have been disposed of by final judgment or by compromise and settlement.

On April 15, 1965, a jury found Poirier & McLane not liable for the claims asserted by Bronxville-Palmer. On September 8, 1969, the New York Court of Claims awarded Bronxville-Palmer $11,600, plus interest on one of its negligence claims against New York. The record does not reveal the results of the Brooklyn litigation. Subsequent litigation dealt primarily with the appropriate interest to be paid by New York. *Bronxville-Palmer* v. *State of New York*, 34 App. Div. 2d 714, 309 N.Y.S. 2d 672, 673 (3d Dept. 1970) *rescinded* 36 App. Div. 2d 10, 318 N.Y.S. 2d 57 (3d Dept. 1971), *modified* 30 N.Y. 2d 760, 284 N.E. 2d 577 (1972).

[4] 63 T.C. 570 (1975).

I.

An understanding of the Congressional purpose in enacting § 461(f)[5] is essential before we can determine the appropriate interpretation to be given Regulation 1.461-2(c)(1). The legislative history of § 461(f) plainly reveals that the statute was designed to reestablish and slightly enlarge a narrow exception to the general rules of tax accounting for accrual basis taxpayers, by allowing payments of contested liabilities to be deducted in the year actually paid.

Generally, an accrual basis taxpayer may deduct a liability expense only in "the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy".[6] Where a liability is contingent on the outcome of a contested lawsuit, it is apparent that neither the fact or amount of the expense would be reasonably ascertained, and consequently the expense would not be deductible. *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516 (1943), *Lucas* v. *American Code Co.,* 280 U.S. 445 (1930).

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[5] 26 U.S.C. § 461(f) states:

(f) Contested liabilities.—If—

(1) the taxpayer contests an asserted liability,

(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(3) the context with respect to the asserted liability exists after the time of the transfer, and

(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

[6] Reg. 1.461-1(a)(2).

Until 1960, however, contested tax liabilities actually paid in a given year constituted a narrow exception to this general rule. *Chestnut Sec. Co.* v. *United States,* 62 F. Supp. 574, 576 (Ct. Cl. 1945), G.C.M. 25298, 1947-2 C.B. 39. The Court of Claims noted "It is hardly conceivable that a liability asserted against [the taxpayer], which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws . . ."

This narrow exception to general accrual rules was eliminated by the Supreme Court in *United States* v. *Consolidated Edison,* 366 U.S. 380 (1961). In *Consolidated Edison,* the company, an accrual basis taxpayer, paid an asserted real estate tax under protest to avoid seizure and sale of its property. Although the corporation continued to challenge a portion of the putative tax bill in court, it deducted the entire deficiency in the year paid. The Supreme Court disallowed the deduction for the contested liability holding that with respect to it, all events determining the fact and amount of the obligation had not yet occurred.

In enacting § 461(f), Congress intended to disapprove this unreasonable application of accrual rules. It allowed payments, by both cash and accrual basis taxpayers, to be deductible in the year of transfer. The statute became applicable to all contested liabilities, not merely tax payments, and was intended to "realistically and practically match receipts and disbursements attributable to specific taxable years." 1964 *U.S. Code Cong. and Adm. News* p. 1773. It was Congress's belief that deduction of the payment in the year "actually made" provided a more realistic reporting of income for tax purposes. In effect, § 461(f) enabled the accrual taxpayer to treat payment of contested liabilities, in appropriate circumstances, as two separate tax events. A deduction was authorized when payment was made, and any subsequent refund was treated as income.

Of course, there is no indication that Congress intended to provide a deduction by simply establishing a contingent

liability reserve. Thus, the Senate Supplemental Report[7] clearly stated that a mere entry on the taxpayer's books, the purchase of a bond to secure eventual payment of a judgment, or transfer of funds to an account within the taxpayer's control did not qualify for a deduction. In contrast, the Report indicated that payments to an escrow agent, which placed the assets beyond the control of the taxpayer, were deductible. It is apparent from the legislative history that Congress envisioned the application of § 461(f) to instances resembling that presented in *Consolidated Edison,* where payment had been "actually made". By satisfying the asserted claim, the taxpayer fixed the fact and amount of its liability in that taxable year. Thus, accrual of the liability was warranted.[8]

Payments pursuant to an escrow agreement, in most instances, are made after the parties have disposed of many of the contested aspects in the case and only a limited legal issue remains for resolution. Often, such settlements are made after a *nisi prius* determination of liability and damages, where all that remains open to the losing party is the right to appeal. In such circumstances, we can see little to distinguish a payment to an escrow account from an advance payment of a contested tax liability.

Payments to trusts are not mentioned in the legislative history of § 461(f), for prior to its enactment, there were no tax or any other advantages to be gained by creating a trust to pay contested liabilities. Litigation reserves could be more easily established on the corporation's books

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[7] 1964 U.S. Code Cong. and Adm. News p. 1913.

[8] The dissenting opinion does not seem to comprehend our observation that a contested liability is reasonably fixed and ascertainable when actually paid. This does not, of course, mean, nor did we say, the liability is no longer contingent. *Con Edison* provides the paradigmatic case. The company's payment of the asserted tax assessment was an event that made the liability sufficiently ascertainable to allow accrual in that year. Nonetheless, the liability remained contested, and thus, contingent.

at lesser expense, or by transfer of funds to a specified bank account. The issue in this case, however, is whether Poirier & McLane's unilateral transfer of assets to a reserve held in trust is the equivalent of payment to an escrow account. In sum, does it constitute a tax event that warrants accrual of the liability and tax deduction in the year of transfer? We believe it does not.

Our dissenting brother, in effect, arrives at the opposite conclusion by announcing that "the important condition precedent" in determining if a payment is deductible under § 461(f) is whether the transfer is made "beyond the taxpayer's control." But this overlooks the key consideration that the timing and amount of such transfers may still be entirely within the discretion of the taxpayer, as they were in this case. We do not believe a transfer effectuates the statutory purpose to "realistically match receipts and disbursements for specific taxable years," merely because the funds are placed beyond the taxpayer's immediate control. The phrase our brother refers to appears only in the legislative history dealing with escrow accounts which, as we have indicated, closely resemble direct payments. Nor does the dissenting opinion tell us why the unilateral transfer of funds to a trust unknown to the claimants, sufficiently resembles direct payment of the liability or the typical payment of contested funds to an escrow account so that it would deserve deductibility under § 461(f).

II.

The Commissioner closely followed the outlines of the Senate Report in promulgating Reg. 1.461-2(c)(1).[9] The

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[9] The Regulation states:

(c) *Transfer to provide for the satisfaction of an asserted liability*—(1) *In general.* A taxpayer may provide for the

(*footnote continued on following page*)

Regulation provided that deductions were only permitted for payments to trusts that resembled the escrow agreement specifically described by Congress. It assimilated the two arrangements, by stating that a taxpayer may provide for satisfaction of a contingent liability by a transfer "to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability)."

The language in the Regulation is clear that an essential requirement for deduction is that the claimants must agree to the establishment of the trust. This requisite forms an integral part of the Regulation, and effectuates the intent of § 461(f). And there is a sound reason for this because the agreement of all the parties, in effect, is the equivalent of a direct payment of the asserted claim. It fixes the fact and amount of the liability in a single taxable year, war-

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(footnote continued from preceding page)

satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability. (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. Purchasing a bond to guarantee payment of the asserted liabiilty, an entry on the taxpayer's books of account, and a transfer to an account which is within the control of the taxpayer are not transfers to provide for the satisfaction of an asserted liability. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.

ranting deduction of the payment as a distinct tax event.

The wisdom of this Regulation is manifested by the facts of this case. Poirier & McLane has failed to offer any reason to regard 1964 as the year its liability accrued. The claims against it had been filed more than four years earlier. The only significant event occurring in that year was the Corporation's unilateral decision to establish a contingency reserve. By transferring funds to a trust, rather than an ordinary bank account, it has asserted that a deductible "payment" was made under § 461(f). Unlike the taxpayer in *Consolidated Edison,* however, Poirier & McLane was not *required* to make any payment in 1964. Nor did the exigencies of litigation compel the company to establish the trust. Its decision to do so was totally voluntary, unilateral and principally dictated by tax motives.[10]

A statute designed to "realistically match receipts and disbursements" for specific taxable years should not be interpreted to permit a taxpayer to create a deduction in a year of his choosing by the simple expedient of transfer-

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[10] We do not comprehend our brother's continued emphasis on the fact that Poirier & McLane transferred these funds beyond its control, about which there is no issue. Poirier & McLane, however, had absolute discretion over the timing and the relatively arbitrary amount it alone decided to transfer in trust. We do not believe Congress ever intended § 461(f) to permit taxpayers to unilaterally decide when and in what amount to "manufacture" tax deductions.

The dissenting opinion misreads the statute's requirement that absent a contest, the liability must be deductible in "the taxable year of the transfer (or for an earlier taxable year)." This does not, as the dissenting opinion suggests, controvert our conclusion. Rather, we believe the statute merely reaffirms that general principles of accrual accounting are applicable; since, if not contested, many of the liabilities covered by § 461(f) would be accrued when they became due, rather than when paid. This certainly does not indicate any Congressional intention to give taxpayers the sole choice of years and amount in which to take the deduction.

ring assets to a trust.[11] Protests that the Regulation places taxpayers in an "unnatural litigating position" by requireing disclosure of their evaluation of the claim are irrelevant. The statute does not purport to grant a "right" to a deduction. Rather § 461(f) authorizes a departure from the general principle of accrual in very limited circumstances, and taxpayers like Poirier & McLane, whose contested liabilities never became reasonably ascertainable, may not take shelter under its narrow roof.

The requirement that claimants be made parties to the trust agreement is also a useful safeguard against abuses of 26 U.S.C. § 461(f). Unlike direct payments to plaintiffs, transfers to trusts can form great potential for misuse. There is little reason to assume solicitude by the settlor towards the beneficiary of such a trust. There may be a strong temptation for the taxpayer not to relinquish full control, especially when the trustee is a personal friend rather than a disinterested bank.

If the claimants are aware of the trust arrangement, as they are required to be under the Regulation, they can ensure that its assets remain beyond the taxpayer's control. While it is true that the trustee has an independent duty to safeguard trust property, only the person asserting the liability is likely to be zealous in objecting to a breach of that duty.[12] In a trust such as Poirier & McLane's, where

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[11] Such a deduction resembles the "anticipatory accrual" disapproved by the Tax Court in *Overlakes Corp.* v. *CIR,* 41 T.C. 503 (1964) *aff'd* 348 F.2d 462 (2d Cir. 1965) *cert. denied* 382 U.S. 988 (1966).

[12] We believe that the source of this Regulation lies in the legislative history of § 461(f) rather than the intricacies of trust law. We would note, however, that whether the settlor or creditors are beneficiaries of a trust established for the payment of creditors is a question of intent. 2 Restatement of Trusts 2d § 330 h, *see also Ehag Eisen. Holding AG* v. *Banca Nat. a Romaniei,* 306 N.Y. 242,

(*footnote continued on following page*)

claimants were never aware of its existence, this important prophylactic measure was lost.

We conclude, therefore, that the assent of the person asserting the liability is required under Reg. 1.461-2(c)(1)(ii). This requirement is an integral means of effectuating the legislative intent of 461(f). Mindful of the strong presumption in favor of the validity of Treasury Regulations, *Commissioner* v. *South Texas Lumber,* 333 U.S. 496 (1948), we conclude the Regulation is a reasonable interpretation of the statute.

The trust created by Poirier & McLane concededly did not comply with the requirements of Regulation 1.461-2(c)(1)(ii) as we have interpreted it. Accordingly the Corporation's payments were not deductible in 1964. The decision of the Tax Court is reversed and remanded with instructions to recompute Poirier & McLane's tax liability for the years in question, disallowing the deduction of $1,100,000 in 1964.

MANSFIELD, *Circuit Judge* (Dissenting):

I respectfully dissent for the reason that the accrual-basis taxpayer in this case, having fully complied with both the letter and the spirit of § 461(f) of the Internal Revenue Code and of Regulation 1.461-2(c)(1) as reasonably construed, was entitled to deduct the payment made irrevocably by it in trust to Manufacturers Hanover Trust Co. to satisfy liabilities asserted against it in a much larger amount, which were then being contested by the taxpayer. The majority, in denying deductibility on the ground that

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(*footnote continued from preceding page*)

251-252 (1954). But if the transfer is pursuant to an agreement with the creditor, the terms of the agreement are controlling on this question. It would not be unreasonable for the Commissioner to allow a deduction under § 461(f) only for trusts that meet this objective standard.

the claimants did not sign the trust instrument, acts on the basis of newly-devised theories as to Congress' intent which find no support in the language, purpose, or legislative history of § 461(f). Indeed, not one of the ten-member panel of the Tax Court (either of the majority or the minority) and no party to this litigation has ever suggested or endorsed the reasoning or theory advanced by the majority. The reason for this is plain—the theory is contrary to the plain language and purpose of the statute.

Section 461(f) was adopted by Congress in 1964 in part to meet the problem created by the Supreme Court's decision in *United States* v. *Consolidated Edison Co. of New York,* 366 U.S. 380 (1961), which held that an accrual-basis taxpayer, even though it had paid a contested tax liability under protest, was not entitled to accrue the payment as a deductible expense until the year when all those events occurred which would determine the fact and amount of the liability. Congress modified this requirement in § 461(f) by expressly authorizing the taxpayer to deduct an amount transferred beyond its control to satisfy an asserted liability contested by it, provided that "but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year)." The legislative history of § 461(f) reveals that Congress' purpose was to permit the taxpayer to match the deduction with the year in which the transfer was actually made, thus bringing it closer to the period when the income to which it is chargeable was received, rather than to wait until the fact and amount of the liability would finally be determined, which might (as in this case) take several years.

The important condition precedent to deductibility under § 461(f) was that funds placed in trust or escrow to satisfy contingent contested liabilities be put "beyond the taxpayer's control." S. Rep. No. 830, Part 2, 88th Cong.,

2d Sess. 243 (1964). To implement § 461(f) Treas. Reg. § 1.461-2(c) was adopted. It specifies that the taxpayer may provide for satisfaction of an asserted liability in contest "by transferring money or other property beyond its control . . . to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, . . ."

In the present case the taxpayer faced liabilities asserted by nine claimants totalling $14,781,150, which it contested. It transferred $1,100,000 not as self-controlled "contingency reserve" (as the majority would have it) but beyond its control to the Manufacturers Hanover Trust Co. for the benefit of the claimants, pursuant to a written agreement which provided that the fund be used to satisfy the claims after the fact and amount of the liability had been determined. It retained only such interest as might remain after the claims had been satisfied. The trust instrument provided that the "sole purpose" for which the funds transferred to the trustee could be used was the payment of the alleged obligations to the nine specifically designated beneficiaries. Aside from the fiduciary responsibilities to the beneficiaries which the instrument imposed on the trustee under New York law,[1] the trust agreement expressly limited the trustee's right to make any disbursements prior to termination of the litigation to those "required to satisfy and discharge the obligation and responsibility" of the settlor to the named beneficiaries. Moreover, there is not the slightest suggestion that the trustee, Manufacturers Hanover Trust Company, was or might be inclined to act illegally or against the interest of the named beneficiaries. Nor has the appellant shown that the taxpayer/settlor

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[1] *In re Bond and Mortgage Guarantee Co.*, 303 N.Y. 423, 103 N.E.2d 721 (1952); N.Y.E.P.T.L. § 11-2.1(a) (McKinney's 1967).

could have revoked the trust at his own initiative or have invaded the fund set aside for the benefit of the claimants. There is no evidence that the taxpayer's transfer of funds to the trustee was not made in good faith or that the taxpayer had any reason to believe that the litigation would eventually result in a reduction of the liability to but a fraction of the amount asserted.

Thus the payment satisfied the plain language of § 461(f) and of Treas. Reg. 1.461-2(c) by placing the money beyond the taxpayer's control to satisfy a contested contingent liability. Although the trust agreement was signed by the taxpayer and by the trustee but not by the claimants, the latter, by the clear intent of the taxpayer/settlor, were just as much parties to it as if they also had signed it, since under its terms and applicable New York law, they acquired irrevocable rights once the fund was transferred to the trustee; thereafter the trustee could not, absent the beneficiaries' consent, return the funds to the taxpayer without becoming liable. See N.Y.E.P.T.L. § 7-19; *Schoellkopf* v. *Marine Trust Co.*, 267 N.Y. 358, 196 N.E. 288 (1935). The terms of this trust fall under the rule that a settlor "may manifest an intention to create a trust in favor of the creditor and to give him an interest in the property of which the debtor cannot subsequently deprive him by revoking the disposition." Restatement of Trusts 2d § 330, Comment h.

In denying deductibility the majority bases its holding on some assumptions which strike me as being both unfounded and illogical. First, it erroneously asserts that Congress intended § 461(f) to apply only to instances "where payment had been 'actually made'" to the claimant, since "[b]y satisfying the asserted claim, the taxpayer fixed the fact and amount of its liability in that taxable year." Nothing in the language or legislative history of § 461(f) supports this bald *ipse dixit*. On the contrary, the

report of the Senate Committee on Finance (S. Rep. No. 830), which accompanied the bill (H.R. 8363, Revenue Act of 1964), made it clear that the statute was designed to permit deduction of payments made in satisfaction of liabilities that might be contingent as to amount rather than substantially fixed, subject to the condition that any overpayment would have to be included by the taxpayer in reportable income in the year when this amount of the liability would ultimately be determined. On this subject, the Report states:

> "To the extent that deductions are allowed under this rule and then subsequently as a result of the contest the items were found not to be payable, adjustment can be made for this overstatement of the deduction by the inclusion of the overstatement in income in the year in which the amount of the liability is finally determined.
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> ". . . The amendment provides that if a taxpayer contests an asserted liability, such as a tax assessment, but makes a payment in satisfaction of this liability and the contest with respect to the liability exists after the payment, then the item involved is to be allowed as a deduction or credit in the year of the payment. This is based upon the assumption that the deduction or credit in this case would have been allowed in the year of payment, or perhaps in an earlier year when it would have been accrued, had there been no contest.
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> "The treatment provided here can be illustrated by an example. Assume that in 1965 a $100 liability is asserted against a business which it pays at that time but contests the liability in a court action. Assume further that in 1967 the court action is settled for $80. Under present law, before the enactment of this provision, the deduction of $80 would be allowed in 1967. Under your committee's action, the taxpayer could

claim a $100 deduction in 1965 but then in 1967 would have to take $20 into income except as provided in section 111 of the code, relating to recovery of bad debts, prior taxes, and delinquency amounts." S. Rep. No. 830, 88th Cong., 2d Sess. 100-101 (1964).

The majority seeks to avoid this plain statement of legislative intent by suggesting that Congress was referring to payments made pursuant to "escrow" agreements rather than "trust" agreements and that a payment made under an escrow agreement is somehow or other a more final and binding recognition of the fact and amount of the taxpayer's liability than is a payment into an irrevocable trust to satisfy the claim, even though in both cases the liability and amount may not yet be determined. Under the "trust" agreement in the present case, just as under the "escrow" agreement to which the majority refers, the money is placed by the taxpayer beyond his control, and the trustee, just like the escrowee, is obligated to use it to satisfy the contested claim when the taxpayer's liability and the amount due are ultimately fixed. The trustee, like the escrowee, may return any overpayment to the taxpayer who is then obligated to declare it as income in the year of receipt.

The trust agreement, therefore, is the legal equivalent of the escrow agreement and does not represent, as the majority characterizes it, a "reserve" or a bank account under the taxpayer's control. Furthermore, in paying the money to an escrowee, which is conceded by the majority to be permissible under § 461(f), the taxpayer has just as much "discretion over the timing" and over the amount to be paid as he does in making the payment to a trustee as in the present case. Undoubtedly it was for this reason that the Commission, in enacting Regulation 1.461-2(c)(1)(ii), uses the terms "trustee" and "escrowee" interchangeably in describing transfers that will satisfy § 461(f).

In short, the payment made by Poirier and McLane was no more unilateral, arbitrary or fixed in amount than a payment into escrow which, the majority concedes, is authorized by § 461(f). The effect of the majority's restrictive interpretation is to limit the availability of § 461(f) whether by trust or escrow to those "all or nothing" contests where the amount of the claim is substantially undisputed and the issue or contingency turns on whether the taxpayer is liable at all.

The majority further proceeds to reason that the claimant's signature on the trust agreement is required since it "fixes the fact and amount of the liability, warranting an accrual taxpayer to take the deduction when payment is made." Aside from the erroneous assumption that the amount of the liability must be fixed during the year of the deduction (already discussed above), I find no logic in the further assumption that a claimant's participation would tend to fix the amount of the liability or that it might promote a policy of limiting the deduction to the lowest amount within reasonable range of the anticipated liability. On the contrary, before signing the claimant would prefer, and might insist, that the largest possible amount be transferred in trust or escrow—in this case some $14,781,500 instead of the $1,100,000 transferred in trust—in the interest of insuring payment of his claim, preferably in the full amount. The majority's assertion that Treas. Reg. 1-461-2(c) requires the claimant's signature on the trust agreement could therefore only have the adverse effect of encouraging deductions at the highest range of possibilities since no litigating claimant would agree to a lesser amount for fear of an uncollectible judgment or of prejudicing his litigation position or possible settlement of his claim.

The majority's additional assertion that the signature of the beneficiary on a § 461(f) trust would somehow serve the purpose of matching the deduction with the year of the alleged accrual of the liability is unrealistic and at odds with the language of § 461(f). In enacting the statute, Congress recognized that the accrual method taxpayer could not hope uniformly to take his deduction in the same year as the alleged liability would have been payable but for the contest; its expressed purpose was to overturn the Supreme Court's holding in *Consolidated Edison,* which restricted the availability of the deduction to the year of the final adjudication of the dispute. That the taxpayer might have some choice as to the year when the deduction might be taken is recognized by § 461(f)(4), which states that a qualifying "deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year)." Even accepting as a goal the desire to restrict the taxpayer's choice of the year when the deduction might be taken and assuming that it would be more equitable to have the deduction taken in a year closer to the occurrence of the facts giving rise to the disputed claim so as to accurately match that year's receipts with disbursements chargeable to that year's operations, the requirement that the beneficiary sign the trust agreement would contribute nothing toward achieving that goal. On the contrary, the signature requirement here imposed by the majority might well delay the deduction because the claimant could use the requirement as a bargaining chip in negotiations. Furthermore, there is no assurance that the taxpayer would propose the creation of either a trust or escrow in any given year.

For the foregoing reasons I construe Treas. Reg. 1.461-2 (c) as not requiring the nine claimants' signatures on the trust instrument in the present case, and I conclude that § 461(f) was fully satisfied by the taxpayer's transfer of

the trust fund beyond its control to satisfy their contingent claims. This interpretation not only accords with the language and purpose of the statute but makes it unnecessary to hold, as would be required if the word "among" as used in the Regulation were construed as requiring the claimants' signatures on the trust agreement, that the Regulation to such extent is unlawful for the reason that it adds a condition and restriction not contemplated by Congress and not reasonably necessary to accomplish Congress' purpose. See *Morrill* v. *Jones,* 106 U.S. 466, 467 (1882); *Miller* v. *United States,* 294 U.S. 435, 439 (1934); *Koshland* v. *Helvering,* 298 U.S. 441, 447 (1936); *Manhattan General Equipment Co.* v. *Commissioner of Internal Revenue,* 297 U.S. 129, 134 (1936).

I would affirm.

Opinion of the United States Tax Court.

63 T. C. No. 55

UNITED STATES TAX COURT

POIRIER & MCLANE CORPORATION, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2662-72. Filed March 10, 1975.

Suits were filed against petitioner for damages totaling $14,781,150 allegedly resulting from trespass and negligence claimed to have been committed in carrying out two construction jobs. Petitioner contested the claims but, on Dec. 31, 1964, transferred $1,100,000 in trust for the sole purpose of the payment of its obligations on the pending claims, taking a deduction for that amount on its 1964 return. Judgments ultimately awarded to the claimants were small in amount, eliminating the need for the funds transferred to the trust, and the transferred funds were returned to petitioner.

Held: The $1,100,000 was transferred to the trustee in accordance with sec. 461(f), I.R.C. 1954, and is deductible in computing petitioner's income tax liability for 1964.

Edward S. St. John and *Thomas P. Dougherty,* for the petitioner.

Rufus H. Leonard, Jr., for the respondent.

OPINION

FEATHERSTON, *Judge:* Respondent determined a deficiency in petitioner's Federal income tax for 1964 in the amount of $624,485.37. Some of the issues have been settled, and the sole issue remaining for decision is whether

Opinion of the United States Tax Court.

petitioner is entitled to a deduction for 1964 under section 461(f)[1] for the amount of funds transferred in trust under an instrument reciting that the sole purpose of the transfer was to provide funds for the payment of certain obligations as finally determined in pending litigation. The answer depends, more specifically, upon (1) whether the funds were placed beyond petitioner's control pending the settlement of the claims, and (2) whether the trust instrument was defective in that it was not signed by the persons asserting liability against petitioner.

All the facts are stipulated.

During the tax year in issue, petitioner Poirier & McLane Corporation (hereinafter petitioner), whose principal offices were located in Yonkers, New York, was a New York corporation engaged in the building of highways, viaducts, and tunnels. Petitioner prepared its income tax returns on the basis of the calendar year, employing the accrual method of accounting.

In January 1956, petitioner entered into a contract with the New York City Transit Authority to reconstruct a subway tunnel and to enlarge a subway station in the Borough of Brooklyn, New York City. Under the contract, petitioner was obligated to hold the New York City Transit Authority harmless from all damage claims resulting from the work to be performed.

As a result of petitioner's performance of the work on this project, the Strand Building Corporation brought an action against petitioner for trespass and negligence. Actions for claimed damages and loss of revenue also were brought by several tenants of other properties located at the construction site. The combined amount of the damages claimed by these plaintiffs was $581,150.

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[1] All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

In October 1958, petitioner entered into a contract with the State of New York as general contractor for the construction of a parkway in Yonkers, New York. Under this contract, petitioner was required to hold the State of New York harmless from all damage claims resulting from the work performed under the contract. To install the necessary pilings, petitioner employed Raymond Concrete Pile Company (Raymond) as a subcontractor. Subsequently, during the driving of these pilings, an adjacent apartment building owned by Bronxville-Palmer, Ltd. (Bronxville), was alleged by Bronxville to have been damaged. In 1960, Bronxville brought actions against the State of New York, petitioner, and Raymond, seeking damages of $14,200,000 for trespass and negligence allegedly arising from pile drivings which trespassed upon Bronxville's property, thereby permanently damaging the foundation and structure.[2]

The carrier of petitioner's liability insurance informed petitioner that its policies did not cover damages arising out of trespass, but that the carrier would undertake to defend all the above-mentioned actions because of the allegations of negligence.

On December 31, 1964, petitioner entered into an agreement, described below, with the Manufacturers Hanover Trust Company, as trustee, to hold United States Treasury Bills and a certificate of deposit for the purpose of the payment of obligations expected to arise out of the litigation outlined above. Establishment of the reserve was prompted by advice given petitioner by its counsel, insurance carrier, and accountant.

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[2] Pertinent reported decisions in the Bronxville litigation include: 224 N.Y.S.2d 524 (1961); 268 N.Y.S.2d 727 (1966); 277 N.Y.S.2d 402 (1966); 309 N.Y.S.2d 672 (1970); 318 N.Y.S.2d 57 (1971); 318 N.Y.S.2d 412 (1971); and 333 N.Y.S.2d 422 (1972).

The amount of the reserve was determined as follows:

Plaintiff	*Amount of Claim*	*Amount of Reserve*
Strand Building Corporation, et al.	$ 581,150	$ 200,000
Bronxville	14,200,000	900,000
	Total	$1,100,000

Petitioner's agreement of December 31, 1964, with the trustee stated that petitioner, designated as settlor, had transferred a certificate of deposit and treasury bills to the trustee to be held in trust "for the sole purpose" of the payment of petitioner's obligations expected to arise out of the litigation pending against petitioner as a result of the two construction jobs. The agreement listed by name the corporations and individuals who had filed the suits to which the agreement referred. The agreement provided in pertinent part:

> 2. The principal and all accumulated interest and earnings shall be held by the Trustee for the sole purpose of the payment of the obligations of the Settlor which may arise out of litigation pending against the Settlor as a result of work performed by it in the construction of the Sprainbrook Parkway in the County of Westchester, State of New York and in the DeKalb Avenue subway reconstruction in the Borough of Brooklyn, County of Kings wherein judgments are demanded against the Settlor and others for damages alleged to have been sustained by the owners and operators of properties adjacent to the places at which the work was performed. The claims and suits to which this agreement refers are those brought against POIRIER & MCLANE CORPORATION by BRONXVILLE

PALMER, LTD., STRAND BUILDING CORPORATION, DEKALB AVENUE RESTUARANT [sic], INC., ROSE DRINKS, INC., GAVARES SERVICE STATION & GLASS WORKS and HENRY A. DUFLON, JEANNE DUFLON CREED & DOROTHY DUFLON SHAFFER.

3. The Trustee shall make such payments out of the corpus of the trust as are required to satisfy and discharge the obligation and responsibility of the Settlor to the plaintiffs or claimants in such litigation, whether by settlement or by judgment and to obtain funds for such purpose the Trustee may sell securities invested in accordance with Paragraph 1. hereof.

4. A request by the Settlor for the issuance of a check or checks payable to a plaintiff or claimant shall be sufficient to empower the Trustee to make the payment.

5. The Trustee shall deliver to the Settlor the balance of the fund remaining after the disposition of the claims on the statement of the Settlor that the claims, for the satisfaction of which this transfer has been made, have been determined and disposed of.

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7. The Trustee may rely and shall be protected in acting or refraining from acting upon any written notice, instruction or request furnished to it hereunder and believed by it to be genuine and to have been signed or presented by the suitor.

8. The Trustee shall not be liable for any action taken by it in good faith and believed by it to be authorized or within the rights or powers conferred upon it by this Agreement, and may consult with counsel of its own choice and shall have full and complete authorization and protection for any action taken or

suffered by it hereunder in good faith and in accordance with the opinion of such counsel.

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13. This trust has been executed and delivered pursuant to the provisions of Section 461-f of the 1964 Revenue Act, in the State of New York and it shall be goverened by the laws of that state.

The trust agreement was not signed by the claimants mentioned in it. Relying on section 461(f), petitioner deducted on its income tax return for 1964 the amount of the funds transferred to the trustee.

The litigation brought by Bronxville, which included numerous claims, commenced in 1960. On September 8, 1969, after trial of the claims, the New York State Court of Claims awarded damages to the plaintiff in the sum of $11,600, plus interest, for negligence on the part of the State.[3] This amount was apparently covered by petitioner's insurance against negligence.

In October 1969, petitioner and its counsel notified the trustee that all claims referred to in the trust agreement were disposed of and that none of the plaintiffs had any present claim against petitioner for damages arising out of the two projects or for any other cause of action whatso-

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[3] Subsequently, the Sept. 8, 1969, judgment of the New York State Court of Claims was modified on questions relating to suspension of interest (309 N.Y.S.2d 672 (1970), 333 N.Y.S.2d 422 (1972)), tolling of the statute of limitations (318 N.Y.S.2d 412 (1971)), and the measure of damages (318 N.Y.S.2d 57 (1971)). As a result of the last-mentioned action, the New York State Supreme Court, Appellate Division, increased the award of damages to Bronxville from $11,600 to $14,204.36 on Feb. 10, 1971. While litigation technically continued after Sept. 8, 1969, the essential merits of the claims were resolved on that date. Moreover, the primary reason for establishing the reserve had been to provide funds to cover possible obligations arising under claims for trespass, a cause of action for which petitioner was not insured.

ever. Petitioner requested return of the trust principal, plus any interest earned. The full amount of the principal of the trust, plus interest, less trustee fees, was returned to petitioner in November 1969. These amounts were not included in petitioner's income on its 1969 income tax return.

Respondent disallowed petitioner's accrual of the reserve transferred to the trustee, determining that the accrual failed to comply with section 461(a)[4] and, alternatively, that petitioner's transfer did not meet the requirements of section 461(f).

Under the accrual method of accounting, which petitioner used, an expense is deductible for the taxable year in which "all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Sec. 1.461-1(a)(2), Income Tax Regs.; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516 (1944). Notwithstanding this rule, however, the Internal Revenue Service generally took the position, prior to 1961, that the payment of a contested liability resulted in the item being considered deductible even though it was still contested. In 1961, the Supreme Court decided *United States* v. *Consolidated Edison Co.*, 366 U.S. 380 (1961), holding that a contested tax, though paid, does not accrue as a deduction for income tax purposes until the contest is terminated. The Court reasoned that, as long as the contest persists, all events determining the fact and amount of the liability have not occurred.

The effect of the *Consolidated Edison* decision, denying a taxpayer a deduction for contested items that have been

[4] SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) General Rule.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

paid, was to thwart the objective of matching receipts and disbursements attributable to specific taxable years. Believing that "allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction * * * until the contest is settled," S. Rept. No. 830, 88th Cong., 2d Sess. (1964), 1964-1 (Part 2) C.B. 505, 604, Congress adopted section 461(f) in 1964, which is as follows:

> (f) Contested Liabilities.—If—
>
> (1) the taxpayer contests an asserted liability,
>
> (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,
>
> (3) the contest with respect to the asserted liability exists after the time of the transfer, and
>
> (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),
>
> then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

Although *Consolidated Edison* dealt with disputed tax liabilities, it will be noted that section 461(f) refers to any asserted liability. Moreover, the section deals not only with liabilities which have been paid but also with the transfer of money or other property "to provide for the satisfaction of the asserted liability." The accompanying

Senate Report (S. Rept. No. 830 (Part 2), 88th Cong., 2d Sess. (1964), 1964-1 (Part 2) C.B. 700, 746) explains that: "A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to the person who is asserting the liability, or by a transfer to an escrow agent provided that the money or other property is beyond the control of the taxpayer." The objective was to allow deductions for sums transferred to pay such asserted liabilities in the year in which the related income was earned rather than in some later year when the contest over such liabilities was settled—"to realistically and practically match receipts and disbursements attributable to specific taxable years." S. Rept. No. 830, 88th Cong., 2d Sess. (1964), 1964-1 (Part 2) C.B. 505, 604.

In the instant case, petitioner was contesting the suits of various claimants and, on the advice of counsel, transferred $1,100,000 to the Manufacturers Hanover Trust Company to be held in trust "for the sole purpose" of the payment of any obligations ultimately determined in those suits. The trustee was authorized to make such payments to the designated claimants out of the corpus as were required to satisfy the obligations of petitioner and, "after the disposition of the claims," to return the balance to petitioner. As the subsequent events unfolded, petitioner successfully defended the lawsuits. All the money was returned to petitioner in 1969,[5] but there is no question as to the bona fides of the claims against petitioner or the transfer to the trustee. Indeed, the parties have stipulated that the $1,100,000 "reserve was set up by petitioner on the advice of * * * [its] counsel, insurance carrier and accountants."

[5] Although the amount returned to petitioner was not reported as income on its 1969 income tax return, as contemplated by sec. 1.461-2(a)(3), Income Tax Regs., petitioner agrees on brief that, upon a resolution of this issue in its favor, it will file an amended return reporting it as income in that year.

We think these facts demonstrate that the transfer meets the requirements of section 461(f).

Respondent contends that the entrusted funds were not transferred "beyond the control" of petitioner and that the transfer, therefore, does not meet the requirements of section 461(f) as amplified by section 1.461-2(c)(1), Income Tax Regs.[6] In support of this argument, respondent argues that the paragraphs of the trust agreement quoted above reserved to petitioner "the right to revoke or terminate this trust at will" by "means of a mere statement that these claims had been determined and disposed of." He reads the above-quoted paragraph 7 of the agreement as relieving the trustee "of any obligation to look behind the contents of the statement submitted by the settlor." On this ground, respondent maintains that

[6] Sec. 1.461-2 Timing of deductions in certain cases where asserted liabilities are contested.

(c) *Transfer to provide for the satisfaction of an asserted liability*—(1) *In general.* A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. Purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, and a transfer to an account which is within the control of the taxpayer are not transfers to provide for the satisfaction of an asserted liability. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.

petitioner remained the absolute owner of the entrusted funds so far as the rights of creditors are concerned, citing *City Bank Farmers Trust Co.* v. *Cannon,* 291 N.Y. 125, 51 N.E.2d 674 (1943).[7]

The trust instrument is certainly not a model of clarity, but we do not think the trust was subject to revocation by petitioner. An analysis of the instrument, quoted in pertinent part above, shows that it placed the entrusted funds beyond the control of petitioner until the enumerated claims were settled. Paragraph 2 of the instrument states that the funds were to be held by the trustee for the "sole purpose" of the payment of petitioner's obligations in the pending suits by named claimants instituted in connection with the two construction jobs. Those claimants became beneficiaries of the trust, and petitioner became a contingent remainderman, entitled to the balance remaining after the disposition of the claims.

To make the purpose of the trust even more explicit, paragraph 3 authorized the trustee to make payments "required to satisfy and discharge the obligation and responsibility" of petitioner to the plaintiffs in such litigation. No other payments from the trust fund were authorized. Paragraph 4 provided that a request by petitioner for the issuance of a check or checks payable to a claimant would be sufficient to empower the trustee to make such a payment. Significantly, this authorization refers only to payments to a claimant, i.e., a beneficiary of the trust.

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[7] N.Y. Est., Powers & Trusts Law sec. 10-10.6 (McKinney 1967), formerly N.Y. Real Prop. Law sec. 145 (McKinney 1945), is as follows:

> Where a creator reserves an unqualified power of revocation, he remains the absolute owner of the property disposed of so far as the rights of his creditors or purchasers are concerned. L.1966, c.952, eff. Sept. 1 ,1967.

Paragraph 5, on which respondent relies to contend that the trust was revocable, merely provided that the trustee would deliver to petitioner "the balance of the fund remaining after the disposition of the claims." The mechanics for the release of the funds "after the disposition of the claims" was a statement by petitioner that all claims had been "determined and disposed of." As contingent remainderman, petitioner, then and only then, would be entitled to the balance remaining in the fund.

Paragraph 7 does not relieve the trustee of any obligation to look behind any statement presented to it by petitioner, as contended by respondent, but refers rather to a request "believed by it [the trustee] to be genuine and to have been signed or presented by the suitor," i.e., a claimant.[8] Indeed, the reference in paragraph 8 to "action taken by it [the trustee] in good faith and believed by it to be authorized" contemplated that it would consult its own counsel on the payment of the funds and on other problems related to the administration of the trust.

Thus, the only ways in which petitioner could have influenced the handling of the entrusted funds were to request the trustee to make a payment to a claimant-beneficiary, thus carrying out the purpose of the transfer, and to request that the balance be returned after the disposition of the claims, i.e., after the objective of the trust had been accomplished. In administering the trust, the trustee, subject to the supervision of a local court with equity powers, had the normal duties of independent judgment and inquiry, *Mills* v. *Bluestein,* 275 N.Y. 317, 323, 324,

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[8] Par. 7 is ambiguous, but the reference to the signature of a *suitor* clearly forecloses respondent's argument that the paragraph relieves the trustee of the necessity of looking behind any statement presented by *petitioner.* The paragraph may have been intended to deal with conflicting claims by the several beneficiary-claimants in case the deposited funds were not adequate to pay the full amount of the judgments awarded.

9 N.E.2d 944, 946 (1937); inflexible loyalty to all the beneficiaries, *In re Bond & Mortgage Guarantee Co.*, 303 N.Y. 423, 103 N.E.2d 721 (1952); and complete neutrality in protecting the respective interests of the claimants as beneficiaries and of petitioner as contingent remainderman, N.Y. Est., Powers & Trusts Law sec. 11-2.1(a) (McKinney 1967), formerly N.Y. Pers. Prop. Law sec. 27-a (McKinney Supp. 1965). In no way could petitioner have reacquired or otherwise controlled the entrusted funds until the purpose of the trust had been achieved. We think petitioner made a genuine transfer of the funds beyond its control within the meaning of section 461(f)(2) as interpreted by section 1.461-2(c)(1), Income Tax Regs., quoted in the margin.

Respondent's second argument is based on that portion of regulations section 1.461-2(c)(1) which states that a taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to an escrowee or trustee pursuant to a written agreement "(among the escrowee or trustee, the taxpayer, and the person who is asserting the liability)." Since the several claimant-beneficiaries did not sign the trust agreement, respondent contends that the agreement does not comply with the regulations and will not support the claimed deduction. Petitioner argues that the regulation, so applied, is impractical,[9] unreasonable, and invalid in that it adds restrictions and conditions to the statute.

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[9] In his opening statement, petitioner's counsel forcefully stated the practical considerations in these words:

> it is completely unreasonable, in an adversary proceeding, to have the claimant a party to that agreement; to have the plaintiff know that there is $1,100,000.00 waiting for it if it can obtain or make a settlement. The probability of collection is always a factor in any settlement that's negotiated in actions of this type. • • •

(*footnote continued on following page*)

We agree with petitioner that the claimant-beneficiaries' failure to sign the agreement does not disqualify petitioner for the deduction. However, petitioner's position is too broad. The regulation need not be declared invalid. Properly interpreted, the regulation simply does not require the signatures of the claimant-beneficiaries in this case.

Initially, it is pertinent that section 461(f) allows the deduction where, among other things, "the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability." Nothing in this language or its legislative history (S. Rept. No. 830, *supra*, 1964-1 (Part 2) C.B. at 604-605 and (Part 2) 745-748) suggests that the person asserting the liability need sign the transfer agreement.

A trust may be created even though the beneficiary has no knowledge of its creation and has not accepted its benefits. Rarely does a beneficiary sign a trust agreement, and his signature or the lack thereof does not affect the trust's validity. In the case of *In re Prudence Co.*, 24 F. Supp. 666 (E.D. N.Y. 1938), a company, prior to the 1933 "Banking Holiday," sold "Prudence-Bonds" on weekly or monthly installments, and when the purchaser had paid a required amount a bond would be issued. The company, without notifying the purchasers, segregated the installment moneys paid toward the purchase of the bonds for which the payments had not been completed. Holding that the company held the segregated funds as trustee for the creditor-purchasers, even though they did not know

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(*footnote continued from preceding page*)

From the standpoint of claimants, it may be equally impractical to require them to sign such an agreement lest they thereby implicitly limit their claims at the outset of the litigation to the entrusted amount, which may represent only a fraction of their total claims (e.g., $1,100,000 compared with $14,781,150 in this case).

of the segregated funds, the court said (p. 668):

> Whether this account is to be treated as a special fund for the benefit of the subscribers or is to be treated as part of the general assets of the debtor, depends upon the effect to be given to the unilateral segregation of the funds in a special account when viewed in the light of all the circumstances. The creation of a trust requires no fixed form or phrase. *The failure to notify the cestui que trust of the creation of the special interest in his favor, does not prevent the creation of a trust.* Steel Cities Chemical Co. v. Virginia-Carolina Chemical Co., 2 Cir., 7 F.2d 280; Sinclair Cuba Oil Co., S. A., v. Manati Sugar Co., 2 F.Supp. 240, D.C.S. D.N.Y.; Rogers Locomotive & Machine Works v. Kelley, 88 N.Y 234, 235; see Beaver Board Cos. v. Imbrie, 2 Cir., 296 F. 670, 672; 1 Bogert, Trust and Trustees (1935) § 172, p. 502. • • • [Emphasis added.][10]

Accordingly, the failure of the claimant-beneficiaries to sign the trust agreement did not prevent the creation of a valid trust or add any rights to petitioner as grantor or as contingent remainderman. Upon the creation of the trust, the Manufacturers Hanover Trust Company, as trustee, became obligated to effectuate the purpose of the trust—the payment of the claims against petitioner. N.Y. Est., Powers & Trusts Law sec. 11-2.1 (McKinney 1967), formerly N.Y. Pers. Prop. Law sec. 105 (McKinney Supp. 1965).

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[10] To these citations on the lack of the necessity to notify the beneficiaries of the creation of a trust may be added numerous others, e.g.: *Woodside Presbyterian Church* v. *Burden*, 269 N.Y. Supp. 682, 687-688, 240 App. Div. 43 (1934), appeal dismissed 264 N.Y. 690, 191 N.E. 629 (1934); *In re Sweeney's Estate*, 279 N.Y.Supp. 927, 930, 155 Misc. 461 (1935); 1 Restatement (2d), Trusts, sec. 36*a* (1959); 1 Scott, Trusts, sec. 36 (3d ed. 1967).

Thus, neither section 461(f)(2) nor its legislative history reflects any congressional intent to require a trust agreement executed for the purposes of that section to be signed by the beneficiaries.[11] Indeed, the disputed regulation itself says nothing about the signatures of the beneficiaries of a trust. As a matter of practice, a trust agreement is rarely signed by a beneficiary. The trust agreement in this case, signed only by petitioner and the trustee, created rights in the claimant-beneficiaries which were exactly the same as they would have been had the beneficiaries signed the instrument. The trustee had the same fiduciary duties and obligations to protect the rights of the claimant-beneficiaries, and the claimant-beneficiaries had the same remedies. Similarly, the rights of petitioner as grantor and contingent remainderman were exactly the same.

In these circumstances, the trust agreement was "among the • • • trustee, the taxpayer, and the person[s] who • • • [were] asserting the liability" to the same extent

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[11] While sec. 461(f) is addressed to the problem of the deductibility of contested liabilities rather than to the rights of the taxpayer's creditors, we note that in the instant case, protection of the rights of the claimant-beneficiaries who were to be paid from the trust fund was not affected by their apparent lack of knowledge of the trust's creation. As a practical matter, had judgments been entered ultimately for the plaintiffs, petitioner almost certainly then would have disclosed the trust fund rather than allow a levy to be made on its other property for the payment of those judgments. Under such circumstances, if existence of the trust had not been disclosed voluntarily, petitioner's officers would have been subject to examination as to petitioner's assets, N.Y. Civ. Prac. Law sec. 5223 (McKinney 1963), and the trust fund's creation would have been revealed. On learning of the trust, the claimant-beneficiaries would have been entitled to demand of the trustee all information about the trust and its creation for which they had any reasonable use. Bogert, Trusts and Trustees, sec. 961 (2d ed. 1962); 1 Restatement (2d), Trusts, sec. 173 (1959). This would include an inspection of the trust agreement. *Davidson* v. *Blaustein*, 247 F.Supp. 225, 227-228 (D. Md. 1965).

as it would have been had the claimant-beneficiaries signed the instrument. The imprecise language of the regulation—that the agreement is to be "among" the stated parties—was no doubt adopted in order to include situations like this one where the signatures of the claimant-beneficiaries would add nothing.

We hold that the trust agreement complies with the provisions of section 461(f) and of section 1.461-2(c)(1), Income Tax Regs. Allowance of the deduction will serve the congressional objective of matching deductions with taxable receipts to the extent practicable.[12] To reflect the disposition of other issues,

Decision will be entered under Rule 155.

Reviewed by the Court.

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[12] While petitioner ultimately prevailed in the underlying litigation, the question of accrual must be viewed as of the date of the transfer. As noted in the text, there is no suggestion that the transfer in trust was not made in good faith or that it did not reflect a realistic appraisal of petitioner's exposure to liability in the year in which its related earnings became taxable.

FORRESTER, *J.*, concurring: I concur in the result reached by the majority, but think the here critical portion of regulations section 1.461-2(c)(1) should be declared invalid if it is read as requiring the claimant-beneficiary to sign the written agreement.

The Code requires taxpayer to transfer money or property against the asserted liability, and the regulation quite properly requires it placed beyond taxpayer's control by a written agreement. But requiring the signature of the claimant adds nothing to taxpayer's loss of control and at the same time destroys, or at least limits and narrows, his rights as remainderman. He is forced into the unnatural posture of admitting and defining his adversary's strength during negotiations with him, thus limiting taxpayer's field for maneuver.

The Code does not require this penalty. If the regulation does it is invalid.

FAY, STERETT, GOFFE, and WILES, *JJ.*, agree with this concurring opinion.

HALL, *J.* I respectfully dissent. The "transfer" in this case did not meet the literal requirements of Treasury Regulation Section 1.461-2(c)(1) that a qualifying transfer under Section 461(f)(2) must either be made "(i) to the person who is asserting the liability," or "(ii) to an escrowee or trustee pursuant to *a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability)* * * *." (Emphasis added.) The "transfer" therefore cannot qualify unless, as the majority holds, the Regulation's requirement was a mere inadvertence or imprecision upon which the Commissioner may not rely, or unless, as Judge Forrester's concurring opinion finds, the Regulation is invalid. Being unable to agree with either of these views, I would sustain the deficiency.

As I read the Regulation, the Treasury has deliberately construed the statute to prevent a secret trust from qualifying. A trust is usually created by agreement *between* trustor and trustee. The unusual requirement here of the beneficiary's participation is, I believe, of great policy significance and was no mere inadvertence.

In fact, the requirement of participation by the other party to the litigation in a qualifying Section 461(f) transfer was even *more* clearly spelled out in the Proposed Regulation:

> A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property *to the person who is asserting the liability, or with the agreement of such person* to an escrowee or trustee to deliver the money or other property in accordance with the settlement of the contest, provided that the money or other property is transferred beyond the control of the taxpayer. [29 Fed. Reg. 9798, 9800 (1964) (Emphasis added).]

The Commissioner, unfortunately, raised a false issue by contesting this case on the ground that the entrusted funds were not transferred "beyond the control" of the petitioner. If that were all that the Regulation required, I would join the majority opinion. I do not doubt that the taxpayer created a valid trust, or that it placed the assets within the trustee's control pursuant to the terms of the trust instrument. But by no legitimate stretch of syntactical interpretation could there be an agreement *among* three parties which was unknown to one of the three.

Nor am I able to find the Regulation invalid. The statute requires a "transfer". That this was not intended to be read entirely literally as covering any kind of transfer, however, is made clear by the Committee Report, which

reads as follows:

> A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to the person who is asserting the liability, or by a transfer to an escrow agent provided that the money or other property is beyond the control of the taxpayer. However, purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, or a transfer to an account which is within the control of the taxpayer is not a transfer to provide for the satisfaction of an asserted liability.

S. Rept. No. 830, 88th Cong., 2d Sess., 1964-1 C.B. (Part 2) 746.

The statute and Committee Report make clear that a transfer to the opponent or to an escrow agent will qualify if the property leaves the taxpayer's control. An escrow, of course, presumes two parties with adverse interests as well as a third party escrow-holder, so that the litigation opponent, inferentially, would at least be aware of any escrow arrangement. The Committee Report does not, however, appear to anticipate the precise issue raised here—the secret trust in which the taxpayer seeks the benefit of the special deduction without the litigation disadvantage of disclosing his hand to the other party. The Regulations do not permit the taxpayer seeking the solace of Section 461(f) thus to have it both ways. In my view this construction does not overreach. In the first place, the legislative history adequately set out in the majority opinion, and the *Consolidated Edison* case, clearly involved only arrangements known to both parties to the litigation. The secret trust was not adverted to by Congress. Secondly, the apparent lack of explicit congressional familiarity with such a device in a litigation context should be no surprise. There would normally be only one motive, a

tax motive, to set up a secret trust. A defendant has too little brotherly solicitude for his opponent to be gratuitously setting up secret trusts for the plaintiff's benefit. Instead of arising in the normal litigation context which Congress adverted to in enacting Section 461(f), the secret trust in the present context is spawned by Section 461(f) itself. It is a rare sport, not to be found in nature. It is simply an effort to enjoy the deduction without the effects on one's litigation posture of disclosure. And since virtually any large company is constantly and increasingly beset as defendant with a swarm of lawsuits of varying degrees of merit, the majority's rejection of the Regulation's deliberately established prerequisites of the litigation opponent's knowledge and participation in a Section 461(f) arrangement opens the door to large-scale avoidance. Deductions will now be subject to being manufactured and timed to please, by the simple expedient of setting aside in secret trusts the amount sought to be deducted, as long as that doesn't exceed the maximum allowable litigation exposure. Little genuine change of business posture is involved, for if the litigation is won, the money will return; if lost the judgment must be paid anyway; in the meantime the secret trustor can enjoy the income, and the litigation opponent is none the wiser. Nothing in the legislative history suggests that Congress intended to establish any such regime, nor does it seem likely that it would have intentionally so legislated. We should resolve doubts in favor of the validity of Treasury Regulations. *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496 (1948). I cannot, under the circumstances, find the Treasury remiss in blocking this avenue to facile avoidance.

Section 461(f) was designed to alleviate a hardship created by a taxpayer who under pressure of litigation was forced to lay out cash before becoming entitled to a

deduction. It was designed to meet bona fide exigencies of business litigation. The issue facing the Treasury in drafting its Regulations was whether the statute should also be construed to permit a taxpayer to thrust himself artificially within its protection through a formalistically perfect arrangement designed for no apparent purpose except qualifying for the deduction, while avoiding the collateral litigation consequences of disclosure to the opponent. I cannot find it beyond the regulatory power for Treasury to decide that such an arrangement would be "an operation having no business or corporate purpose" and to find that "the transaction upon its face lies outside the plain intent of the statute." *Gregory* v. *Helvering*, 293 U.S. 465, 469, 470 (1935).

RAUM, SIMPSON, and QUEALY, *JJ.*, agree with this dissent.

Statute and Regulation Involved.

Statute:

Section 461, (f) *Contested Liabilities*—If—

(1) the taxpayer contests an asserted liability,

(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(3) the contest with respect to the asserted liability exists after the time of the transfer, and

(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

Regulation:

Section 1.461-2. Timing of deductions in certain cases where asserted liabiliites are contested.

(a) *General rule.*—(1) *Taxable year of deduction.* If—

(i) The taxpayer contests an asserted liability.

(ii) The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability.

(iii) The contest with respect to the asserted liability exists after the time of the transfer, and

(iv) But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable),

then the deduction with respect to the contested amount shall be allowed for the taxable year of the transfer.

(2) *Exception.* Subparagraph (1) of this paragraph shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, including a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

• • •

(c) *Transfer to provide for the satisfaction of an asserted liability.*—(1) *In general.* A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. Purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, and a transfer to an account which is within the control of the taxpayer are not transfers to provide for the satisfaction of an asserted liability. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.

Statute and Regulation Involved.

(2) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M establishes a separate bank account in its own name. M then transfers $5,000 from its general account to such separate account. Such transfer does not qualify as a transfer to provide for the satisfaction of an asserted liability because M has not transferred the money beyond its control.

Example (2). M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M transfers $5,000 to an irrevocable trust pursuant to a written agreement among the trustee, M (the taxpayer), and L (the person who is asserting the liability) that the money shall be held until the contest is settled and then disbursed in accordance with the settlement. Such transfer qualifies as a transfer to provide for the satisfaction of an asserted liability. • • •

Congressional Reports.

SENATE REPORT
U.S. CODE CONGRESSIONAL
AND ADMINISTRATIVE NEWS
VOLUME 1
88TH CONGRESS, SECOND SESSION
AT PAGE 1773.

Timing of deductions and credits in certain cases where asserted liabilities are contested (sec. 224 of the bill and sec. 461 of the code)

(a) Present law. — Prior to the decision in the Consolidated Edison case the Internal Revenue Service generally held that the payment of a contested tax liability resulted in the tax being considered as deductible even though the tax was still being vigorously denied and contested. In the Consolidated Edison case decided in 1961 the Supreme Court held that a contested tax even when paid does not accrue as a deduction for income tax purposes until the contest is terminated. It was held that the tax was not deductible until after the contest was settled because all of the events which would determine whether or not the amount would ultimately have to be paid would not be determined until that time.

(b) General reasons for provision. — Although your committee does not question the legal doctrine laid down by the Supreme Court in the Consolidated Edison case, it believes that it is unfortunate to deny taxpayers a deduction with respect to an item where the payment has actually been made, even though the liability is still being contested either as to amount or as to the item itself. The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws

contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled. To the extent that deductions are allowed under this rule and then subsequently as a result of the contest the items were found not to be payable, adjustment can be made for this overstatement of the deduction by the inclusion of the overstatement in income in the year in which the amount of the liability is finally determined.

(c) General explanation of provision.—In view of the above consideration, your committee has amended the provision of the existing law which specifies the year for the taking of deductions or credits generally. The amendment provides that if a taxpayer contests an asserted liability, such as a tax assessment, but makes a payment in satisfaction of this liability and the contest with respect to the liability exists after the payment, then the item involved is to be allowed as a deduction or credit in the year of the payment. This is based upon the assumption that the deduction or credit in this case would have been allowed in the year of payment, or perhaps in an earlier year when it would have been accrued, had there been no contest.

The treatment provided here can be illustrated by an example. Assume that in 1965 a $100 liability is asserted against a business which it pays at that time but contests the liability in a court action. Assume further that in 1967 the court action is settled for $80. Under present law, before the enactment of this provision, the deduction of $80 would be allowed in 1967. Under your committee's action, the taxpayer could claim a $100 deduction in 1965

but then in 1967 would have to take $20 into income except as provided in section 111 of the code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

In those cases where payment is not made until after the contest is settled, this does not prevent an accrual basis taxpayer from accruing the deduction or credit in an earlier year in which the contest is settled.

A similar amendment to that described above is also made to the Internal Revenue Code of 1939.

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Section 224. Timing of deductions and credits in certain cases where asserted liabilities are contested.

Section 224 of the bill, which was added by your committee to the bill as passed by the House, amends section 461 of the 1954 Code (relating to general rule for taxable year of deduction) and section 43 of the 1939 Code (relating to period for which deductions and credits taken), and provides certain transitional rules. No provision of this section of the bill extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

(a) Taxable year of deduction or credit.—Paragraph (1) of section 224(a) of the bill, which was added by your committee to the bill as passed by the House, amends section 461 of the 1954 Code, relating to general rule for taxable year of deduction, by adding to such section a new subsection (f). In G.C.M. 25298, 1947-2 C.B. 39, the Internal Revenue Service took the position that a taxpayer may

deduct the amount of taxes paid to local authorities not later than for the year of payment even though he contests liability for such taxes. In 1961, the U.S. Supreme Court held that, where an accrual basis taxpayer contested taxes paid to local authorities, the contested amount was deductible for the taxable year in which the contest was settled rather than for the taxable year in which such amount was paid (U.S. v. Consolidated Edison Co. (1961) 366 U.S. 380). The new subsection (f), in the case of contested taxes, provides that the contested amount is deductible for the year of payment.

The new subsection (f) provides in effect that if (1) a taxpayer contests an asserted liability (such as a tax assessment); (2) such taxpayer transfers money or other property to provide for the satisfaction of the asserted liability; (3) the contest with respect to the asserted liability exists after the time of the transfer; and (4) but for the fact that the asserted liability is contested, a deduction or credit would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable), then the deduction or credit shall be allowed for the taxable year of the transfer.

The new subsection (f) is not limited to an asserted liability for taxes, but applies to any asserted liability where the requirements of the new subsection (f) are met. A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to the person who is asserting the liability, or by a transfer to an escrow agent provided that the money or other property is beyond the control of the taxpayer. However, purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, or a transfer to an account which is within the control of the taxpayer is not a transfer to provide for the satisfaction of an asserted liability.

The new subsection (f) applies only if the contest with respect to the asserted liability exists after the time of payment. Thus, the new subsection (f) does not apply to Z corporation in the following example:

Example.—Z corporation uses the accrual method of accounting. In 1964 a $100 liability is asserted against Z. Z contests the asserted liability. In 1967 the contested liability is settled as being $80 which Z accrues and deducts for such year. In 1968 Z pays the $80.

If any portion of the contested amount, which is deducted in the year of payment, is refunded when the contest is settled, such portion is includible in gross income except as provided in section 111 of the 1954 Code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

The new subsection (f) may be illustrated by the following examples:

Example (1).—X corporation, which uses the cash method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and X receives a refund of $5. Under the new subsection (f) of section 461 of the 1954 Code, for the taxable year 1964 X deducts $100 and for the taxable year 1968 X includes $5 in gross income (assuming sec. 111 of the 1954 Code does not apply to such amount).

Example (2).—Y corporation, which uses the accrual method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of $5. Under the new subsection (f) of section 461 of the 1954 Code, for the taxable year 1964 Y deducts $100 and for the taxable year 1968 Y includes $5 in gross income (assuming sec. 111 of the 1954 Code does not apply to such amount).

Paragraph (2) of section 224(a) of the bill, as added by your committee, amends section 43 of the 1939 Code, relating to period for which deductions and credits taken, by adding at the end of such section a new sentence. The new sentence is the same as the new subsection (f) added to section 461 of the 1954 Code by paragraph (1) of section 224(a) of the bill.

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Amendment No. 97: This amendment adds a new section to the bill, relating to the time of deductions and credits in certain cases where asserted liabilities are contested.

(a) Taxable year of deduction or credit.—Subsection (a) of the new section amends section 461 of the 1954 code (relating to general rule for taxable year of deduction) and section 43 of the 1939 code (relating to period for which deductions and credits taken) to provide that if—

(1) the taxpayer contests an asserted liability;

(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability;

(3) the contest with respect to the asserted liability exists after the time of the transfer; and

(4) but for the fact that the asserted liability is contested, a deduction or credit would be allowed for the taxable year of the transfer (or for an earlier taxable year); then the deduction or credit shall be allowed for the taxable year of the transfer.

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SENATE DEBATE AT PAGE 1454.

24. Deduction of contested liabilities. The bill would allow a deduction for the taxable year in which a taxpayer pays a tax or other liability, even though he contests the liability.

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SENATE DEBATE AT PAGE 3517.

Sixth. The House accepted the Senate amendment which provides that the year a taxpayer contests a tax or other liability he is, nevertheless, to be permited a deduction for the item in the year for which he makes a payment, if this is earlier than the year in which the contest is settled. It is the understanding of the conferees that the new provisions relating to the timing of deductions, in certain cases where asserted liabilities are contested, do not affect the taxable year in which the taxpayer may deduct items of a nature which are properly accruable in a year before the year of payment.

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HOUSE DEBATE AT PAGE 3562.

Fourteenth. The House conferees accepted a Senate amendment which provides that where a taxpayer contests a tax or other liability he is nevertheless to be permitted a deduction for the item in the year in which he makes a payment, if this is earlier than the year in which the contest is settled.

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Section 223, contested items: Where a taxpayer contests a tax or other liability, he is, nevertheless, to be permitted a deduction for the item in the year in which he makes the payment if this is earlier than the year in which the contest is settled.